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Securities Industry Trends

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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1987'S ROLLER COASTER RIDE - DOWNHILL

The securities industry got up on the right side of the bed as the year dawned. The first quarter brought record revenues and profits to the total spectrum of firm categories. The sunny mood, however, was darkened by the stormy bond markets of April and May. Preliminary results for the third quarter show only marginal improvement while October's events leave full-year results in question.

HIGHLIGHTS

1. No firm category escaped the securities industry's second quarter profit plunge of 74%. Profits collapsed for each category as follows:

National Full Line Firms:	-102%
Large Investment Banks:	- 82%
New York City-Based Firms:	- 67%
Regional Firms:	- 53%
Commission Introducing Firms:	- 16%
Discounters:	- 14%

2. Principal transactions, primarily bond trading, together with minimal expense paring were the main culprits for these declines.

3. Six month results show the industry's profit margin and ROE at their second lowest level of the Eighties. Annualized, 1987's first half ROE and profit margin, respectively, were 22.2% and 9.4%, both pre-tax.

4. Despite problems with the large firms, the Regionals, New York City-based firms, Discounters and Commission Introducing firms had strong six-month results.

5. The industry's pre-tax ROE of 22.2% for 1987's first half compared favorably to other broad based performance measures. Returns on investing in the S&P 500 for the half yielded 25.5%, the NYSE Composite yielded 23.5% and the NASDAQ Composite yielded a lower 21.7%.

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ONLY YESTERDAY

Was it only yesterday or eons ago when the financial press was churning out story after story on huge Wall Street salaries, a 3,000 Dow, and so on.

This month we've seen the tune change to tabloid titles along the lines of 1929 Crash, Financial Meltdown, Panic, etc. Recent events do tend to make an analysis of the securities industry in the first half of this year seem like a course in ancient civilizations. The trends, and the rules, all seem to have changed. After a week like that of October 19 when 2.3 billion shares changed hands at the corner of Wall and Broad, records may no longer seem meaningful. Still, that 2.3 billion shares was two-thirds the Big Board volume for the entire year 1974. Back in 1974, a turning point year for the securities industry when all the numbers began to grow and grow fast, average daily volume on the New York Stock Exchange was just under 14 million shares per day. During the week of October 19, it averaged about 460 million per day.

Now OTC traders weren't exactly on vacation that week either, handling over 1.2 billion shares. That's equal to NASDAQ's 1974 full-year volume. In 1974, average daily NASDAQ volume was under 5 million per day...that week it was about 245 million per day.

It's fair to say that the securities industry has been slightly busy of late. With this type of activity, the agency business is generating record levels of commissions. Back in 1974, commission revenue for the securities industry totaled $2.3 billion. Last year it was $10.5 billion and based on this year's first half, not even adjusting for recent volume levels, it will grow at least another $2 billion this year.

Now what about that first half, "Ancient Civilizations 101." The equity markets were bullish and then the big headlines were covering the second quarter's bond trading fiascos.

The enormous profits trading can generate for a firm has tantalized senior management into devoting more and more capital to this area of the business and even has them scrambling to find new sources of capital - Japan, going public, corporate partners, etc. - to throw at this area. Above average returns can be made where risk is involved - and trading is risk. However, with one-quarter of the securities industry's revenues dependent on this risk area, not to mention other risk areas, and only one-fifth of the revenues now coming from that nice safe commission business, things can go bad, and very bad, with adverse markets...and they did!

Table 1

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	3,298.4	2,970.9	(9.9)
Trading Profits	3,878.5	1,868.2	(51.8)
Debt Portion	2,595.4	907.0	(65.1)
Investment Gains	769.2	294.4	(61.7)
Underwriting	1,448.6	1,479.3	2.1
Equity Portion	327.3	472.1	44.2
Margin Interest	699.5	849.0	21.4
Mutual Fund Sales	790.1	611.9	(22.6)
Fees, Account Supervision	375.2	454.7	21.2
Research	24.6	6.8	(72.4)
Commodities	245.4	420.9	71.5
Other Securities Related	2,460.0	3,020.3	22.8
Other Unrelated	661.3	627.1	(0.5)
Total Revenues	14,650.9	12,604.0	(14.0)
Expenses			
RR Compensation	2,570.7	2,296.1	(10.7)
Clerical Compensation	2,507.0	2,269.6	(9.5)
Partner/Officer Comp.	402.3	387.6	(3.7)
Other Employee Comp.	152.5	182.4	19.6
Floor (Commission/Clearing)	513.0	533.9	4.1
Communications	606.7	629.1	3.7
Occupancy & Equipment	619.1	657.8	6.3
Promotional Costs	272.0	292.2	7.4
Interest Expense	3,307.0	3,521.3	6.5
Errors/Bad Debts	126.4	202.7	60.4
EDP	175.5	179.3	2.2
Non-Recurring Charges	4.5	5.8	28.9
Regulatory Fees	78.0	84.7	8.6
Other	1,284.5	829.5	(35.4)
Total Expenses	12,619.5	12,072.0	(4.3)
Pre-Tax Net Income	2,031.4	532.2	(73.8)

PUTTING ALL YOUR EGGS IN ONE BASKET

When Wall Street's profits tumbled in the second quarter, it shouldn't have been too big of a surprise. When you have all, or at least most, of your eggs in one basket - in this case principal transactions, particularly bond trading - the basket will go sour when the market moves against you.

April's and May's spiking of interest rates, not in small part due to an attempt to strengthen the U.S. Dollar, caught many a firm with long positions in Treasuries, munis, mortgage-backed, and other fixed income instruments. The result - major losses at many firms and an across-the-board hit for everyone long in bonds!

The industry has been steadily gravitating towards principal transactions as the industry's prime revenue source for years. Trading and investments accounted for less than 10% of revenues whereas commissions generated more than half of all revenues in the early 1970s. The industry gradually shifted its revenue dependence from commissions to trading where recently about one-third of revenues were driven by principal transactions while only about one-fifth were derived from commissions.

This held true in 1987's record first quarter. One-third of that quarter's record $14.7 billion in revenues came from trading and investments. This translated into record quarterly profits of just over $2 billion. However, the rocky bond markets in the second quarter caused trading and investment revenues to plummet over $2.4 billion, or more than 50%, with a resultant 74% decline in profitability! These principal transactions, the new "bread and butter" business line thus fell to around 17% of all Q2 revenues...the lowest level on an annualized basis in a dozen years.

Most of the decrease came from bond trading. The net gain from debt trading collapsed to $907 million in the second quarter, down $1.7 billion or off 65% from the first quarter's $2.6 billion net gain! This accounted for the bulk of the $2 billion revenue drop-off which, when tempered by a $500 million reduction in expenses, translated into a $1.5 billion slash in net income - again, a jolting 74% drop!

Since the 10 National Full Line firms and the 10 Large Investment Banks (see Table 16 for firm category synopsis) accounted for 90% of the first quarter's bond trading gains and total trading gains, it should be no surprise that it is these same firms that experienced 90% of the overall drop in these revenue areas. But even though these large firms experienced the lion's share of the <u>aggregate</u> plummet, the havoc of the second quarter's trading losses on firms' bottom lines was not limited to these two groups of large firms.

For the NFLs, trading gains plummeted nearly $900 million, more than accounting for the $750 million drop-off in revenues and $525 decline in profits. In fact, the NFLs <u>lost</u> $13 million in Q2 vs. a $512 million pre-tax profit in Q1.

For the LIBs, principal transactions were down $1 billion from Q1; a steeper decline than the $766 million revenue shortfall and $475 million drop in profits would otherwise indicate.

The same held true for Regional firms. Principal transaction revenue dropped $105 million in the second quarter, shy of the $125 million revenue shortfall but outpacing the $92 million drop in profits.

For the New York City-based Regionals, principal transaction revenues nosedived by over $300 million. This compares to about a $240 million drop in both revenues and profits. These firms, however, took a bigger hit in the investment area vs the trading area...two-thirds of the fall off came from investment accounts.

Taking a look at the past 10 quarters (Table 2), it is graphically obvious that the performance of the securities industry in principal transactions (trading and investment gains) is highly correlated to total revenues and profits. In all but the fourth quarter of last year, whenever principal transaction gains rose from the previous quarter, or fell, revenues and profits moved in the same direction. More important, a majority of the time the level of movement of revenues and/or profits closely matched the level of movement in the principal transaction area!

Table 2

QUARTER TO QUARTER CHANGE IN PRINCIPAL TRANSACTION REVENUES VS TOTAL REVENUES AND PRE-TAX PROFITS

(In $ Millions)

Quarter	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	87:2
Principal	57	62	(452)	1216	1099	(1177)	(393)	(215)	1874	(2531)
Revenues	432	284	(393)	2756	1311	(445)	(711)	1208	1691	(2047)
Profits	431	91	(318)	767	476	(619)	(266)	101	865	(1499)

Commission revenues fell 10% in the second quarter to $3.0 billion from $3.3 billion, mirroring the decline of activity on the major exchanges as well as the OTC market. Based on SIA's "Investor Activity Report," purchases and sales on the NYSE, AMEX and NASDAQ during the second quarter fell two billion shares short of the amount transacted in the first quarter.

Underwriting revenues, on the other hand, were surprisingly up (although by only 2%) since the volume of corporate and municipal offerings in the second quarter was $98 billion, down 20% from the first quarter's $122 billion (Table 3). Equity underwritings picked up the most; revenues were up 44% to $472 million, although equity underwriting volume only rose 5% to $17 billion, many more smaller-sized deals took place.

Table 3

UNDERWRITING VOLUME

(In $ Billions)

Security	87:Q1	87:Q2	% Change
Municipal Bonds	32.6	29.9	(8.3)
Corporate Bonds	73.5	68.2	(23.7)
Corporate Equity	15.9	16.7	5.0
Total	**122.0**	**114.8**	**(5.9)**

Source: IDD Information Services

Margin interest revenue was one of the few areas of revenue growth in the second quarter. Climbing $150 million from the first quarter's $700 million, or 21%, the improvement was due to two factors. First, margin debt balances, as reported by the NYSE, rose $3 billion in the second quarter to $39 billion. On that bigger base, the second quarter's higher interest rate environment, which was a downside to trading, compounded the rate of return for margin interest. On the other hand, the gain was wiped out by over $200 million more in interest expense (which is partially incurred to finance customers' margin debit balances) which shows that despite Charles Lamb's theory that "the human species is composed of two distinct races, the men who borrow, and the men who lend," there's no such segregation in the securities industry.

Quarterly mutual fund revenues fell for the first time since 1985, down 23% to $612 million which is also the lowest quarterly total since 1985. According to the Investment Company Institute, sales of open-end mutual funds (which this FOCUS revenue line tracks) also fell substantially, down 27% in the second quarter to $51 billion.

Besides asset management and commodities businesses, which showed higher returns in the second quarter of this year, "other securities related" businesses showed a healthy 23% increase or over half a billion more in revenue dollars during the second quarter.

This revenue line's main contributors are revenues from repo and reverse repo activities and from two investment banking areas: merger & acquisition fees and private placement fees.

M&A activity didn't contribute to the revenue increase. According to IDD Information Services, M&A transaction volume fell 30% in the second quarter to $31.6 billion from $43.3 billion in Q1. The number of transactions was also down, 888 in Q2 vs. 1030 in Q1. W.T. Grimmm & Co., the Chicago-based merger consultants, says that net M&A announcements in the second quarter were the lowest quarterly figure since they began tracking this field 24 years ago.!

The outlook for these revenues for the balance of the year looks flat. Third quarter M&A activity was brisk but screeched to a halt during October's market massacre. Ironically, the market crash began in takeover stocks when arbitrageurs unloaded due to the uncertainty of takeover legislation, including proposed limitations on of the tax deductibility of interest on bonds issued to finance takeovers.

This situation could, however, reverse and reverse rapidly when legislative uncertainties are settled in light of the current drastically reduced market prices of almost all public companies.

Private placement activity, on the other hand, was up sharply in the second quarter. IDD's data shows second quarter private placement volume more than tripling to $43 billion from $14 billion. The number of placements also came close to tripling going from 312 deals in Q1 to 874 in Q2.

On the flip-side of the income statement, total expenses also fell from the first quarter's record level of $12.6 billion. But the drop, only 4% or $1.5 billion, fell far short of revenues' decline leaving the bottom line down 74% from Q1's record $2 billion to $532 million.

Compensation costs' reductions mirrored declines in production levels. With compensation the single biggest expense of this industry, had this expense not been curtailed as revenues declined, industry results would have been even more disastrous. Further reductions in this main expense will occur, particularly during this final quarter, based on the employment reductions now underway.

Other than compensation, however, basically <u>every other expense item increased</u> during the second quarter - a situation which is intolerable if a bottom line is to be salvaged in even rougher times. Interest expense, as mentioned earlier, increased with interest rate levels. Other expense items, such as floor expenses, communications, occupancy and equipment, etc., rose marginally but again did so as revenues were plummeting.

Although third quarter figures are not yet available, reports from publicly held firms indicate this situation may not have alleviated much and the fourth quarter has gotten off to a horrendous start with 1929-style markets in October.

Table 4

STATEMENT OF INCOME
NATIONAL FULL LINE FIRMS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	1,444.5	1,225.1	(15.2)
Trading Profits	1,658.3	796.0	(52.0)
Debt Portion	1,088.0	429.0	(60.6)
Investment Gains	71.0	54.6	(23.1)
Underwriting	718.2	652.9	(9.1)
Equity Portion	167.3	237.6	42.0
Margin Interest	372.5	421.3	13.1
Mutual Fund Sales	563.0	426.4	(24.3)
Fees, Account Supervision	157.1	201.3	28.1
Commodities	133.8	261.1	95.1
Other Securities Related	854.2	1,186.5	38.9
Other Unrelated	110.0	104.1	(5.4)
Total Revenues	6,082.8	5,329.2	(12.4)
Expenses			
RR Compensation	1,525.6	1,407.0	(7.8)
Clerical Compensation	1,255.4	1,133.0	(9.7)
Partner/Officer Comp.	64.8	54.8	(15.4)
Floor (Commission/Clearing)	122.0	131.0	7.4
Communications	359.9	367.4	2.1
Occupancy & Equipment	351.9	371.5	5.6
Promotional Costs	151.2	158.5	4.8
Interest Expense	1,035.1	1,162.1	12.3
Errors/Bad Debts	88.9	137.4	54.6
EDP	60.1	60.9	1.3
Non-Recurring Charges	4.0	4.9	22.5
Regulatory Fees	41.6	50.7	21.9
Other	509.9	303.0	40.6
Total Expenses	5,570.5	5,342.2	(4.1)
Pre-Tax Net Income	512.3	(12.9)	(102.5)

NATIONAL FULL LINE FIRMS POST IN THE RED

Only one group of firms posted an annual loss as a group this decade: the 10 National Full Line firms (NFLs) which lost $118 million (pre-tax) in 1984. The NFLs also were the only group to post in the red in this year's tough second quarter. Revenues fell 12% while expenses declined a much smaller 4% for a 103% dive in bottom line results from $512 million in pre-tax profits in Q1 to $13 million in losses in Q2 - a $525 million decrease.

As mentioned earlier, the NFLs' trading gains plummeted nearly $900 million, more than accounting for the $750 million drop-off in revenues and $525 million decline in profits. In underwriting, the NFLs experienced a 9% decline in revenues in the second quarter, more in line with what happened in underwriting volume than the industry's 2% revenue increase. The decline means that these 10 firms captured 44% of total underwriting revenues in Q2 vs. 50% in the first quarter.

Margin interest revenues grew 13% for the NFLs which lagged the industry's 21% climb while drop-offs in mutual fund revenues mirrored the industry's decline.

Asset management (fees), commodities and "other securities related" revenues increased at slightly better rates than the industry as a whole leaving the NFLs' total revenue decline of 12% slightly less severe than the industry's 14% drop.

On the expense side of the income statement, the NFLs tracked the industry with declines in compensation matching production drops but with increases across the board in all other expense lines. Overall, the NFLs' 4% rise in expenses matched the industry's increase.

Table 5

PRE-TAX PROFIT MARGINS

(In Percent)

Firm Category	80	81	82	83	84	85	86	87*
National Full Line	10.9	6.9	8.8	8.6	(0.9)	5.6	6.9	4.4
Large Investment Banks	17.7	15.4	17.4	16.7	11.4	14.6	13.5	8.8
Regionals	14.7	11.2	11.1	12.6	2.6	9.4	11.0	9.6
New York City Based	14.8	12.6	14.0	18.3	8.9	12.3	16.1	17.7
NYSE Discounters	17.5	12.2	13.6	14.0	0.3	8.9	15.7	17.4
Commission Introducing	16.9	10.9	15.9	18.8	9.5	19.8	22.1	28.0
Total Industry	**14.1**	**10.8**	**13.1**	**12.9**	**5.2**	**10.7**	**11.0**	**9.4**

*First half

As the previous table shows, for the half the NFLs are running with a razor thin pre-tax profit margin of 4.4%, the lowest level of the 80s sans 1984's loss.

The NFLs' pre-tax return on equity, as the above table shows, was nearly halved in the first half to 11.7% from last year's 20.3%. Again, it was the worst showing, sans 1984, for this group during the 80s. The results are also only half the industry norm and are again the lowest showing of all firm categories.

Table 6

PRE-TAX RETURN ON EQUITY

(In Percent)

Firm Category	80	81	82	83	84	85	86	87*
National Full Line	45.0	24.6	29.8	28.1	(2.6)	17.9	20.3	11.7
Large Investment Banks	55.7	56.7	54.8	43.8	31.1	38.5	34.2	18.4
Regionals	N.A	37.2	36.0	40.5	6.8	29.0	32.7	27.2
New York City Based	N.A	42.1	43.3	50.7	19.9	31.2	35.4	38.9
NYSE Discounters	N.A	52.2	53.9	46.7	0.8	25.6	49.5	43.9
Total Industry	**49.2**	**35.9**	**40.5**	**36.6**	**13.3**	**29.4**	**28.6**	**22.2**

*First Half

The industry's employment of equity in doing a securities business returned 22.2% before taxes during the first half. If it had employed all of its equity in investing in the stocks of various broad indexes it in most cases could have done only slightly better. As Table 7 shows, investing in these broad indexes would have given returns of between 20% and 30% (which would also be pre-tax until liquidated), close to the industry's ROE and several groups of firms far exceeded these returns.

Table 7

FIRST HALF 1987 PERFORMANCE MEASURES

(In Percent)

Index	% Change
Dow Jones Industrial Average	+27.56
Standard & Poor's 500	+25.53
Standard & Poor's 400	+30.38
NYSE Composite	+23.45
NASDAQ OTC Composite	+21.74
AMEX	+28.44
Value Line	+19.05
Wilshire 5000	+23.41

Table 8

STATEMENT OF INCOME
LARGE INVESTMENT BANKS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	465.7	421.4	(9.5)
Trading Profits	1,559.2	637.3	(59.1)
Debt Portion	1,243.4	391.4	(68.5)
Investment Gains	181.4	66.5	(63.3)
Underwriting	511.0	568.2	11.2
Equity Portion	66.7	117.7	76.5
Margin Interest	110.3	153.8	39.4
Mutual Fund Sales	12.5	13.6	8.8
Fees, Account Supervision	73.3	103.4	41.1
Research	14.3	0.4	(97.2)
Commodities	88.6	122.2	37.9
Other Securities Related	969.6	1,167.1	20.4
Other Unrelated	306.0	272.4	11.0
Total Revenues	4,292.0	3,526.4	(17.8)
Expenses			
RR Compensation	440.9	331.3	(24.9)
Clerical Compensation	665.4	599.7	(9.9)
Partner/Officer Comp.	167.5	161.6	(3.5)
Floor (Commission/Clearing)	103.8	115.8	11.6
Communications	102.1	114.2	11.9
Occupancy & Equipment	120.0	135.1	12.6
Promotional Costs	57.9	68.6	18.5
Interest Expense	1,583.0	1,645.6	4.0
Errors/Bad Debts	12.2	48.3	295.9
EDP	57.3	58.5	2.1
Regulatory Fees	10.6	9.5	(10.4)
Other	390.4	132.0	(66.2)
Total Expenses	3,711.1	3,420.1	(7.8)
Pre-Tax Net Income	580.9	106.3	(81.7)

LARGE INVESTMENT BANKS HIT HARD

The 10 Large Investment Banks (LIBs) had a disastrous second quarter as Table 8 illustrates. Revenues nosedived 18% while expenses were only curtailed by 8% causing the bottom to fall out of profits - an 82% pre-tax plummet to $106 million in the second quarter.

Principal transactions, that sharp two-edged sword, showed its uglier half when revenues from this source crumbled by $1 billion in Q2. Over 85% of that drop came from bond trading alone.

Commission revenues' 10% decline matched the industry's shortfall; however, the LIBs were able to show revenue improvements from almost all other sources. Underwriting's profits rose 11% while the equity portion mushroomed by 77%, margin interest climbed nearly 40% and account supervision fees showed similar improvements.

Nonetheless, the LIBs couldn't weather the Titan-missile-size hit principal transactions sustained in the second quarter. The damage from the $1 billion slamming of revenues more than wiped out other gains for a total drop in revenues of $766 million and a $475 million clipping of profits.

As was true with the industry, the pairing of expenses in the second quarter was almost entirely from the compensation levels paid. But these curtailments were not enough to offset the broadside in principle businesses.

So, the second quarter's damage sunk the LIBs' first half profit margin and ROE to levels below the industry norm for the first time in the Eighties and to their lowest levels (on an annualized basis) this decade!

Table 9

STATEMENT OF INCOME
REGIONAL FIRMS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	482.9	441.4	(8.6)
Trading Profits	268.9	176.7	(34.3)
Debt Portion	113.2	72.9	(35.6)
Investment Gains	21.2	8.3	(60.8)
Underwriting	150.8	196.4	30.2
Equity Portion	61.8	95.2	54.0
Margin Interest	67.6	74.8	10.7
Mutual Fund Sales	194.9	156.3	(19.8)
Fees, Account Supervision	24.0	27.0	12.5
Research	2.2	5.2	136.4
Commodities	11.0	15.0	36.4
Other Securities Related	124.8	125.6	0.6
Other Unrelated	25.5	22.7	(11.0)
Total Revenues	1,373.8	1,249.3	(9.1)
Expenses			
RR Compensation	393.1	365.2	(7.1)
Clerical Compensation	248.7	209.4	(15.8)
Partner/Officer Comp.	80.2	90.0	12.2
Other Compensation	28.0	38.1	36.1
Floor (Commission/Clearing)	64.6	61.5	(4.8)
Communications	78.9	79.4	0.6
Occupancy & Equipment	64.6	61.7	(4.5)
Promotional Costs	32.4	33.9	4.6
Interest Expense	86.4	98.7	14.2
Error/Bad Debts	12.3	8.5	(30.9)
EDP	20.1	20.5	2.0
Non-Recurring Charges	0.2	0.8	300.0
Regulatory Fees	9.5	9.9	4.2
Other	82.1	91.2	11.1
Total Expenses	1,201.5	1,168.8	(2.7)
Pre-Tax Net Income	172.3	80.5	(53.3)

REGIONALS RIDE OUT THE WAVE

For Regional firms, the bad news is - profits were slashed in half during the second quarter. The good news is - that's not as bad as the 103%, 82%, 74% and 67% drops experienced by the NFLs, LIBs, the total industry and the New York City-based regionals, respectively.

Principal transaction revenues fell $105 million in the second quarter, nearly the entire $125 million total revenue shortfall for Regionals. Commissions, which make up a hefty 35% of Regionals' total revenues, their number one revenue source, fell 9%, the same percentage drop as total revenues from Q1 to Q2.

Mutual fund sale revenues, also an important contributor to revenues, 13% to 14% of late, were also hit relatively hard in the second quarter - dropping 20%. Everything else, however, fared well. Underwriting revenues rose 30% overall with equity's portion up 54% in Q2. Margin interest climbed 11%, asset management fees rose 13% while commodities revenues increased by more than one-third.

Rollbacks in expenses such as compensation, floor costs and errors and bad debts during the second quarter, which were cut by about $50 million, were offset by increases of around $20 million in other expenses, more than half of that from interest costs alone.

The result was that expenses were pared by about $30 million while revenues were slashed by $125 million which cut profits in the second quarter in half.

The following table shows, however, that the Regionals did not fare as well as the industry and the LIBs in the first quarter but outperformed these groups in the second quarter as well as the total six month period.

Table 10

PRE-TAX PROFIT MARGINS

(In Percent)

Firm Category	87:Q1	87:Q2	YTD
National Full Line	8.4	(0.2)	4.4
Large Investment Banks	13.5	3.0	8.8
Regional Firms	12.5	6.4	9.6
New York City-Based Firms	24.3	9.7	17.7
NYSE Discounters	18.8	16.0	17.4
Commission Introducing Firms	30.5	25.4	28.0
Total Industry	13.9	4.2	9.4

In fact, as Table 5 showed earlier, Regionals' profit margins on an annual basis since 1980 have always lagged the LIBs and only last year did they catch up to the industry average. So, for the first time, based on the first six months, Regionals' profit margins now exceed the LIBs and the industry average.

The story is similar for the Regionals' pre-tax ROEs. As another earlier example showed, Table 6, Regionals' annual ROEs during the 80s always lagged the LIBs and often lagged the industry average. Table 11 below shows that for both the first and second quarters as well as the half, the Regionals' ROE has for the first time outpaced that of the LIBs and also outpaced the industry average. And the first half's results are pretty much in line with the ROEs the Regionals have experienced during the past two years of the bull market.

Table 11

PRE-TAX RETURN ON EQUITY

(In Percent)

Firm Category	87:Q1	87:Q2	YTD
National Full Line	24.6	(0.6)	11.7
Large Investment Banks	31.4	5.5	18.4
Regional Firms	37.6	17.1	27.2
New York City-Based Firms	61.8	17.6	38.9
NYSE Discounters	53.5	35.1	43.9
Commission Introducing Firms	73.5	48.2	58.6
Total Industry	36.1	8.9	22.2

Table 12

STATEMENT OF INCOME
NEW YORK CITY-BASED REGIONALS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	396.0	380.0	(4.0)
Trading Profits	268.7	162.2	(39.6)
Debt Portion	86.4	14.1	(83.7)
Investment Gains	227.2	30.2	(86.7)
Underwriting	38.6	26.2	(32.1)
Equity Portion	22.2	10.0	(55.0)
Margin Interest	39.5	59.1	49.6
Mutual Fund Sales	14.5	10.8	(25.5)
Fees, Account Supervision	71.7	73.9	3.1
Research	1.4	0.6	(57.1)
Commodities	3.0	11.3	276.7
Other Securities Related	275.5	332.5	20.7
Other Unrelated	117.2	126.7	8.1
Total Revenues	1,453.2	1,213.6	(16.5)
Expenses			
RR Compensation	130.6	123.2	(5.7)
Clerical Compensation	198.1	183.8	(7.2)
Partner/Officer Comp.	47.3	34.6	(26.8)
Other Compensation	58.7	65.6	11.8
Floor (Commission/Clearing)	75.2	79.6	5.9
Communications	33.1	34.4	3.9
Occupancy & Equipment	40.4	43.9	8.7
Promotional Costs	16.1	18.6	15.5
Interest Expense	348.6	366.4	5.1
Error/Bad Debts	4.4	3.6	(18.2)
EDP	12.5	13.4	7.2
Non-Recurring Charges	0.2	0.1	(50.0)
Regulatory Fees	7.9	7.4	(6.3)
Other	127.2	121.1	(4.8)
Total Expenses	1,100.5	1,095.5	(0.5)
Pre-Tax Net Income	352.8	118.1	(66.5)

NEW YORK CITY-BASED REGIONAL FIRMS

Commissions, which make up about 30% of the New York City-based Regionals' (NYCs) revenues, fell slightly, 4%, in the second quarter. Trading, however, dropped by $107 million, a 40% decline. That put trading at only 13% of the NYCs' Q2 total revenues, down from 18% in Q1.

Investment gains, which made up 16% of all first quarter revenues, almost dried up completely in Q2, plunging 87% or by nearly $200 million. A revenue source which contributed 16% of Q1 total revenues provided only 2% in Q2.

Combining these two principal activities, there is a drop of over $300 million from Q1 to Q2, far outpacing the $240 million drop in total revenues and the $235 million drop in pre-tax profits.

Looking at it another way, principal transactions accounted for one-third of the NYCs' total revenues in the first quarter but only 15% in Q2!

"Other Securities Related" revenue, again M&A, private placements and repos making up the bulk, climbed 21% for the NYCs in Q2. In the second quarter, this revenue source made up over one-quarter of the NYCs' total revenues, second only to commissions' 31% contribution.

Overall, revenues were down nearly 17%, a further drop than the industry's 14% shortfall. Total expenses, however, remained level, falling a mere one-half percentage point or $5 million.

Wile revenues were slashed by $240 million, compensation dropped only $28 million. A full $18 million of that cutback was offset by rising interest expense. The bottom line was cut by two-thirds from Q1 to Q2.

As was true with their Regional cousins, the NYCs, helped by a phenomenal first quarter, still have pretty good first half results. Their six-month profit margin of 17.7% was better than all their annual results during the Eighties except for 1983's 18.3% showing. Their annualized first half ROE of 38.9% was also their best showing since 1983.

Still, despite the six-month profitable results, the NYCs reliance on trading, investments and fees, such as M&A, does not bode well with what is currently happening to these business lines in the second half!

Table 13

STATEMENT OF INCOME
NYSE DISCOUNTERS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	176.7	174.2	(1.4)
Margin Interest	40.0	50.1	25.3
All Other	86.1	83.5	(3.0)
Total Revenues	302.8	307.8	1.7
Expenses			
Total Compensation	74.6	75.5	1.2
Floor (Commission/Clearing)	44.9	41.9	(6.7)
Communications	13.2	12.7	(3.8)
Occupancy & Equipment	11.7	14.5	23.9
Promotional Costs	6.9	6.2	(10.1)
Interest Expense	33.5	41.1	22.7
Error/Bad Debts	2.5	1.6	(56.3)
EDP	12.5	14.6	16.8
All Other	46.0	50.5	9.8
Total Expenses	245.8	258.6	5.2
Pre-Tax Net Income	57.0	49.2	(13.7)

NYSE DISCOUNTERS HANG TOUGH

Although all firm categories showed profit declines during the second quarter, the NYSE Discounters experienced the least - down less than $8 million or 14%. In fact, their revenues increased nearly 2% despite a small drop in their prime revenue source, commissions. What caused the drop was an increase in expenses. All categories discussed so far showed at least some expense reduction in the second quarter, albeit reductions short of the reductions in revenues. Discounters experienced 5% higher expenditure levels in Q2 which is not a good sign when markets are moving against you.

A positive sign, although their stock prices do not reflect it, is that the Discounters will be helped, at least temporarily, from the huge amount of agency commission business, which is more than half their revenue base, experienced so far in the second half. The downside of this, however, is that this group's primary customer base, the retail investor, may be scared out of the markets by October's fiasco for some time to come. Only time will tell.

For the first six months, Discounters' profit margins and ROEs, as seen in earlier tables, also were very healthy and outpaced the industry averages.

Table 14

STATEMENT OF INCOME
COMMISSION INTRODUCING FIRMS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	128.7	128.2	(0.4)
Trading Profits	49.9	53.0	6.2
Investment Gains	23.6	10.2	(56.8)
Underwriting	8.6	14.5	68.6
Fees, Account Supervision	14.4	10.0	(30.6)
All Other	24.6	37.9	54.1
Total Revenues	249.8	253.8	1.6
Expenses			
Total Compensation	69.4	79.8	15.0
Floor (Commissions)	22.3	23.3	4.5
Interest Expense	4.5	6.3	40.0
All Other	77.3	79.9	3.4
Total Expenses	173.5	189.3	9.1
Pre-Tax Net Income	76.3	64.5	(15.5)

COMMISSION INTRODUCING FIRMS

Commission Introducing firms (CIs), whose common thread is that they don't carry or clear for their customers' accounts, do not belong in any of the previous categories and file an abbreviated short form FOCUS Report, mirrored the Discounters performance. These firms also receive over half their revenues from the agency commission business and thus will be affected in much the same way that Discounters will be by recent events.

The CIs saw a slight drop in commission revenues but managed a slight increase in total revenues from Q1 to Q2. Their expenses rose 9%, however, for a bottom line drop of 16% in Q2.

Their profit margin for the first half, however, exceeded their annual profit margins in all of the Eighties.

Table 15

SECURITIES INDUSTRY CONCENTRATION

Total Revenues	80	81	82	83	84	85	86	87*
Top 10	53.1%	55.6%	57.3%	54.4%	58.8%	57.5%	57.3%	53.4
Top 11-25	19.4	18.7	18.7	19.6	17.1	19.7	19.8	20.9
Rest of Industry	27.5	25.7	24.0	26.0	24.1	22.8	22.9	25.7
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Total Capital								
Top 10	50.8%	50.0%	54.8%	52.8%	57.2%	63.2%	61.9%	59.9
Top 11-25	18.0	19.7	18.3	18.8	15.6	14.8	16.0	15.9
Rest of Industry	31.2	30.3	26.9	28.4	27.2	22.0	22.1	24.2
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

*Based on first half

CONCENTRATION EASES

As the above table shows, the 10 largest capitalized firms have been giving up, albeit slightly, some of their market share of industry revenues and capital the past few years. The middle tier, the 11th through 25th largest capitalized firms, have been basically holding steady. Both groups' aggregate revenues and capital have been growing, and growing rapidly, but the non-25 largest have been growing even faster, helped somewhat by the addition of more firms to the NYSE over the past few years.

GLASS-STEAGALL

The banking industry of late has stepped up its campaign to garner additional securities powers. Cries of unprofitability and inability to compete with Wall Street for profitable business lines have been lamented. The additional powers banks now seek - commercial paper, municipal revenue and asset-backed bond underwriting chief among them - are only a fraction of the securities business and based on the cutbacks in these areas by major securities firms (who say these areas are unprofitable) it's doubtful how these powers will help banks' bottom lines much.

These business lines are dominated by the largest firms in the securities industry. Let's assume that banks had full securities powers, in fact let's assume that they had the entire businesses of the largest securities firms. How profitable would the banks have been in the first half of this year? The following table shows how the top 10 and top 25 banks would have fared by absorbing the profits of their much smaller cousins.

Clearly, taking over the total business and profits of the 25 largest securities firms (which we just previously saw account for three-quarters of all securities industry revenues) doesn't even dent the fender of the runaway freight train of losses bank mismanagement has sent out of control. But banks are presently targeting just the businesses which large major securities firms are finding unprofitable for themselves.

Table 16

BANKS VS. BROKERS*

First Half 1987
(In $ Millions)

	Top 10 Firms Profits	Capital
Banks	(8,439.4)	80,568.0
Brokers	843.4	20,379.3
Combined	(7,596.0)	
	Top 11-25 Firms	
Banks	(1,938.5)	39,421.1
Brokers	283.0	5,417.5
Combined	(1,655.5)	
	Top 25 Firms	
Banks	(10,377.9)	119,989.1
Brokers	1,126.4	25,796.8
Combined	(9,251.5)	

* Largest bank holding companies by assets, American Banker, 9/30/87. Largest New York Stock Exchange member broker/dealers by capital. Profits are after tax.

This call to end "Glass-Steagall" as a panacea for bank unprofitability is false. A lot of securities firms took a beating in the recent market collapse and one bank, despite the banking industry's promises of separate subs with arms length transactions, violated its maximum one-customer lending ceiling with loans to prop up its securities subsidiary's troubled capital position during the recent crises. It's one thing to claim conflicts of interest can be managed and another to stand idly by while your subsidiaries are teetering.

George R. Monahan
Assistant Director of Research

Table 17

FIRM CATEGORY SYNOPSIS

NFLs	10 largest full service (all brokerage/investment banking, retail institution business lines) with a national branch network system.
LIBs	10 largest investment banking houses. Similar to NFLs in business lines except their client base is predominantly institutional with a resultant absence of many retail services. Also, no meaningful branch network - just money center cities.
Regionals	Similar to NFLs in business lines but much smaller in their size. Also, their branch network systems are mainly localized (Midwest, Southwest, West Coast, etc).
NYC Regionals	New York City-headquartered firms which are similar to Regionals but with a heavier institutional client base and thus more fee and investment income dependent.
Commission Introducing	Introduce commission business but don't carry or clear their own customer's accounts. This group is segregated mainly because they file a short-form (FOCUS) which is not comparable to the long forms. Not a homogenous group other than they are non-carrying and file the short FOCUS.
Discounters	Firms which hold themselves out as discount brokers with retail commissions their dominant revenue source.
Other	All firms which do not meet the criteria for the previous categories (boutiques, specialists, one-product line operations).

VOLUME

	SEPT 1987	YTD 1987	SEPT 1986	YTD 1986	% CHAN YTD 1987-1986
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	177.3	181.1	150.8	140.3	29.1%
AMEX (MILS.)*	12.4	13.7	10.8	12.2	12.0%
NASDAQ (MILS.)*	148.3	149.9	105.4	116.2	29.0%
REGIONAL EXCHANGE (MILS.)*	N/A	N/A	23.4	23.1	N/A
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$163,895	$1,426,618	$124,644	$1,023,761	39.4%
AMEX (MILS.)	4,222	40,585	3,230	32,639	24.3%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	9,481	96,452	8,304	81,475	18.4%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	15,465	157,856	16,716	161,118	-2.0%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.8%	51.3%	47.9%	49.3%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	17,784	146,633	17,758	140,501	4.4%
AMEX OPTIONS	4,733	41,165	3,940	37,181	10.7%
COMMODITY	22,408	171,523	17,122	142,349	20.5%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

UNDERWRITING

	NINE MONTHS 1987	NINE MONTHS 1986	% Change 1987-1986
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$227,679.5	$202,250.4	12.6%
Common Stock	$35,167.7	$30,727.0	14.5%
# of Common Stock Issues	757	882	-14.2%
Preferred Stock	$10,987.5	$9,970.1	10.2%
# of Preferred Stock Issues	153	128	19.5%
Corporate Debt	$181,524.3	$161,553.3	12.4%
# of Corporate Debt Issues	1,326	1,255	5.7%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$57,659.8	$83,378.7	-30.8%
# of Issues	2222	2333	-4.8%
Competitive	$18,903.3	$27,781.9	-32.0%
# of Issues	2426	2965	-18.2%

Source: IDD Information Services

PRICES
(END OF MONTH)

	SEPT 1987	SEPT 1986	% CHAN YTD 1987 1986
DOW JONES INDUSTRIALS	2596.28	1767.58	46.88%
STANDARD & POOR'S 500	321.83	231.32	39.13%
NYSE COMPOSITE	180.24	132.44	35.07%
AMEX MARKET VALUE INDEX	356.45	260.69	36.73%
VALUE LINE COMPOSITE	279.41	222.08	25.82%
NASDAQ COMPOSITE	444.25	350.67	26.70%

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Report on Office Salaries	SIA annual survey report outlines weekly, monthly, and annual base salary information as of July 1, 1987 for 78 non-exempt administrative, secretarial, sales assistant, clerical, and "back office" positions. This 221-page report also illustrates historical trends data and presents detailed listings of salary levels in New York and in 27 major metropolitan areas.	William Jordan SIA Price: $ 50 participants $ 400 non-participating members $1,200 non-SIA members
Report on Management & Professional Earnings	SIA annual survey report details base salaries and bonuses of 128 middle management and professional positions. The report covers management and supervisory personnel in all operations departments as well as the professionals such as auditors, programmers, systems analysts, corporate finance associates, research analysts, and traders. This 321-page study also includes Human Resources Management positions such as compensation managers and analysts, benefits managers and analysts, and interviewers. Data as of 12/31/86 and 5/1/87 are presented.	William Jordan SIA Price: $ 50 participants $ 400 non-participating members $1,200 non-SIA members
"Villain or Scapegoat?--The Heat's on Program Trading"	If the market's crash were to spell the end of program trading, there will be a certain irony. Article explains program trading and portfolio insurance and how during the week of the 19th, program trading--at least as the term is understood by most Wall Streeters--failed to play its normal role.	Barron's 10/26/87

"1987 Nine-Month Corporate Finance Ratings"	During the first three quarters of the year, the total number of issues brought to market fell 1.3% to 2,236 from the same period in 1986, while overall dollar volume rose 12.6%. This is in sharp contrast to the same period for 1986 versus 1985. Moreover, the overall totals for the year to date reportedly would have been softer without the execution of deals using interest rate or currency swaps. Ranking tables includes new category, collateralized securities.	Investment Dealer's Digest 10/5/87
"Wall Street's New Austerity"	Review of reasons for recent cutbacks--retrenchments, job cuts and asset sales--by major securities firms as well as banks. Series of short articles also focuses on Salomon Brothers and the securities industry's impact on New York City.	Business Week 10/26/87
"No More Handouts"	So far this year, broker payout cuts have been mild compared with last year. Most firms left their schedules untouched or instituted only minor changes. Nevertheless, pressures remain especially for low-end producers. Article part of special compensation section.	Registered Representative October 1987
"Moving out from under Paul Volcker's shadow"	A look at the ideology and personality of the president of the New York Fed, E. Gerald Corrigan.	Institutional Investor September 1987